IN THE

Supreme Court of the United States

October Term, 1964

No. 486

W. PALMER DIXON, JOAN DIXON, EVERETT W. CADY, CLARISSA H. CADY, J. HERBERT HIGGINS, MARION BLAIR HIGGINS, STEPHEN A. KOSHLAND, CAROL F. KOSHLAND, HENRY A. LOEB, JOHN L. LOEB, CARL M. LOEB, JR., and MARGARET L. KEMPNER, as Executors of the Last Will and Testament of CARL M. LOEB, SR., Deceased, HENRY A. LOEB, JOHN L. LOEB, CARL M. LOEB, JR., and ALAN H. KEMPNER, as Executors of the Last Will and Testament of ADELINE M. LOEB, Deceased, JOHN L. LOEB, FRANCES L. LOEB, HENRY A. LOEB, LOUISE S. LOEB, CLIFFORD W. MICHEL, BARBARA R. MICHEL, MARK J. MILLARD, CLAIRE MILLARD, HENRY PARISH, 2ND, DOROTHY PARISH, HUBERT R. A. SIMON, SAMUEL L. STEDMAN and GERDA C. STEDMAN,

Petitioners,

against

THE UNITED STATES OF AMERICA,

Respondent.

BRIEF FOR PETITIONER ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BERNARD E. BRANDES,
SANFORD SAIDEMAN,
Attorneys for Petitioners.

Of Counsel:
STROOCK & STROOCK & LAVAN.

INDEX

Citations

PAGE

CASES (Cont'd):

PAGE

PAGE

MISCELLANEOUS (Cont'd):

IN THE

Supreme Court of the United States

October Term, 1964

No. 486

W. PALMER DIXON, JOAN DIXON, EVERETT W. CADY, CLARISSA H. CADY, J. HERBERT HIGGINS, MARION BLAIR HIGGINS, STEPHEN A. KOSHLAND, CAROL F. KOSHLAND, HENRY A. LOEB, JOHN L. LOEB, CARL M. LOEB, JR., and MARGARET L. KEMPNER, as Executors of the Last Will and Testament of CARL M. LOEB, SR., Deceased, HENRY A. LOEB, JOHN L. LOEB, CARL M. LOEB, JR., and ALAN H. KEMPNER, as Executors of the Last Will and Testament of ADELINE M. LOEB, Deceased, JOHN L. LOEB, FRANCES L. LOEB, HENRY A. LOEB, LOUISE S. LOEB, CLIFFORD W. MICHEL, BARBARA R. MICHEL, MARK J. MILLARD, CLAIRE MILLARD, HENRY PARISH, 2ND, DOROTHY PARISH, HUBERT R. A. SIMON, SAMUEL L. STEDMAN and GERDA C. STEDMAN,

Petitioners,

against

THE UNITED STATES OF AMERICA,

Respondent.

BRIEF FOR PETITIONER ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Opinions Below

The opinion of the District Court is reported at 224 F. Supp. 358, and also appears at R. 4-15.* The opinion of the Court of Appeals is reported at 333 F. 2d 1016, and also appears at R. 44-49.

---

* "R." references are to Transcript of Record.

Jurisdiction

The Judgment of the United States Court of Appeals for the Second Circuit was entered on June 19, 1964. The petition for certiorari was filed on September 11, 1964 and was granted on December 14, 1964. The jurisdiction of this court is invoked under 28 U. S. C. 1254 (1).

Questions Presented

1. Whether under the 1939 Internal Revenue Code gain realized on the sale of notes issued at a discount constitutes capital gain or ordinary income in the nature of interest?

2. Where the petitioners relied, in entering into a transaction, upon a Treasury position, evidenced by a published Acquiescence, in a decision of the Tax Court affirmed by the Sixth Circuit (*Commissioner* v. *Caulkins,* 144 F. 2d 482 (6th Cir., 1944), affirming 1 T. C. 656 (1943)), that original issue discount is, when realized by sale or exchange, capital gain, may the Commissioner thereafter to the detriment of the petitioners change his position retroactively and on a discriminatory basis and seek to tax such income as ordinary income in the nature of interest?

Statutes Involved

The relevant sections of the Internal Revenue Code of 1939 are Sec. 42(b), Sec. 42(c), Sec. 111(a), Sec. 117(a)(1), Sec. 117(a)(1)(D), Sec. 117(f), Sec. 125, Sec. 201(e), Sec. 207(d), Sec. 3791(b) and the relevant sections of the Internal Revenue Code of 1954 are Sec. 171, Sec. 483 and Sec. 1232. They are set forth at pages 37 to 47, *infra.*

Statement of the Case

Petitioners, members of the firm of Carl M. Loeb, Rhoades & Co., a partnership, instituted this action for the refund of income taxes and interest alleged to have been erroneously and illegally assessed and collected by the Government from them for the taxable year 1952.

During the c;alendar year 1952, the partnership* acquired certain securities consisting of 33 short-term non-interest bearing promissory notes which had been issued at a discount (R. 28). The notes were purchased, either directly from the issuing obligor corporation or through agents or dealers, on the original date of issue in all but one instance (R. 28-29). The notes had been purchased by the partnership in reliance on the Commissioner of Internal Revenue's interpretation of applicable Sections of the Internal Revenue Code as evidenced by his published Acquiescence in the case of *Caulkins* v. *Commissioner*, 1 T. C. 656, aff'd 144 F. 2d 482 (6th Cir., 1944) (R. 32-34). In that case the Sixth Circuit held that gain realized upon redemption at maturity of a debt obligation in registered form issued at a discount is capital gain since section 117(f) made such redemption the equivalent of an exchange.

Immediately upon acquisition, the promissory notes were segregated and identified as held for investment in accordance with Section 117(n) of the Code (R. 29). From time to time during the year 1952, the partnership sold some of the promissory notes prior to maturity thereof after they had been held by the partnership for a period in excess of six months (R. 29).

The partnership reported the difference between the sales price and its cost as long term capital gain from the sale of capital assets, and the partners reported their respective distributive shares of said capital gain and paid the tax thereon (R. 29). The Commissioner disallowed the petitioners' capital gain treatment on the 1952 sale of the promissory notes, and ruled that discount is when realized ordinary income in the nature of interest (R. 30). The Commissioner computed the income realized as earned by virtue of the discount for each day that each of the 33 notes was held by the partnership both with respect to notes that were sold in 1952 and those unsold at the end of the year

* The argument refers to petitioners rather than the partnership since the former are the taxpayers and not the partnership.

(R. 30). This earned discount per day was then multiplied by the number of days that the notes were held, and the resulting amount was held ordinary income in the nature of earned interest, and each partner-petitioner was held taxable on his distributive share of such ordinary income (R. 30). The deficiencies were paid by the petitioners, claims for refund were filed and denied, and the petitioners thereafter instituted this action in the District Court (R. 30).

On cross-motions for summary judgment, the issues before the District Court were (1) whether the gain attributable to the original issue discount should, under the 1939 Code, be treated when realized by sale or exchange as ordinary income or capital gain and (2) whether in light of the consistent prior Treasury position as evidenced by the Acquiescence in *Caulkins* v. *Commissioner,* which recognized original issue discount when realized as capital gain, may the Treasury despite petitioners' reliance thereon, retroactively and on a discriminatory basis change its position to the detriment of petitioners (R. 5). The District Court granted the Government's motion for summary judgment and dismissed with prejudice the amended complaint of the petitioners (R. 2-3). The Court of Appeals affirmed (R. 50) and the petition for certiorari was granted on December 14, 1964 (R. 51).

Summary of Argument

I.

The first issue involves solely the proper construction of the Internal Revenue Code of 1939 since the taxable year before the Court is the calendar year 1952. As in all matters of statutory construction, the ordinary meaning of words is to be applied in the light of demonstrated Congressional intent and understanding.

A. There are in the Internal Revenue Code of 1939 several special sections which classify original issue discount as an income item. There is not to be found, however, any

section of general application comparable to Section 1232 of the 1954 Code which characterizes discount as other than a capital item, taxable as ordinary income when realized.

To the Court below the difference between the two Codes created no question. The Court's explanation was that the new section of the 1954 Code, for which no prior precedent existed, merely clarified existing law and did not alter it. It was this explanation which enabled the Court below to refuse to apply the provisions of the 1939 Code which recognize a capital gain when capital assets such as the securities here involved are sold at a profit.

The conclusion of the Court below that the 1954 Code merely clarified the prior law cannot be justified. Even the Second Circuit has subsequently changed this conclusion. In *Lubin* v. *Commissioner,* 335 F. 2d 209 (2nd Cir., 1964), decided less than two months after the within case and to which the 1939 Code also was applicable, the Second Circuit held that the discount at which certain securities, had been issued was not, under the facts of the case, when realized ordinary income in the nature of interest and was taxable as capital gains. In reaching its decision, the Court recognized that if the 1954 Code had been applicable, the gain attributable to the discount would have been taxed as ordinary income. Accordingly, to the Court in the *Lubin* case, the 1954 Code did modify prior law.

B. The position of the Court below cannot be upheld in the light of the legislative history concerning the status of discount. In connection with Revenue legislation under consideration in 1929, the Revenue Act of 1938, and even in connection with the enactment of Section 1232 of the Internal Revenue Code of 1954, as well as on other occasions, Congress has demonstrated its awareness of an existing difference in tax treatment between discount and interest. Not only are there these specific characterizations by Congress of discount as a capital item taxable as capital gain when

realized, but in addition, not one instance may be found in the legislative history prior to the 1954 Code wherein Congress has referred to discount as the equivalent of taxable interest or other ordinary income without special legislation, notwithstanding the full recognition of the economic relationship between discount and interest.

It is also clear that from time to time in its consideration of the status of discount in particular situations Congress has decided that discount should not be a capital item. Whenever Congress has come to this conclusion, it has enacted special legislation to classify discount in that situation as an income item and deny it capital gains treatment. Several such instances exist where Congress has enacted as part of the Revenue laws special legislation dealing with discount and providing designated treatment for discount in specified situations. Section 1232 of the 1954 Code is one example of such special legislation differing from the others as to scope in that now the general rule is changed and discount has become an income item unless the amount thereof does not exceed the limits set forth in this Section. The discount involved in the securities before this Court does not fall within any of such special legislative enactments prior to Section 1232 of the 1954 Code.

C. The relationship between yield or interest has already been considered by this Court and its decision therein should govern the disposition of the issue regarding discount. As obligations are from time to time issued at a discount, they are on occasion issued at a premium. The discount affects the "yield" or the amount of compensation paid for the use of money but so does the premium. And yet the Government, contrary to the position which it now takes as regards discount, has ruled that premium, unless there is a special statute, does not affect income but is to be taken into account only on sale or other disposition of the obligation. The Government position as regards premium has been sustained by this Court. *New York Life Insurance Co. v. Edwards*, 271 U. S. 109 (1926); *Old Colony R. Co. v. Commissioner*, 284 U. S. 552 (1932). Accordingly, premium

could affect income only by reason of special legislation which was enacted by Congress as Section 125 of the Internal Revenue Code of 1939. Moreover, under the statute amortization against income of premium on private securities is elective. Accordingly, if in 1952 petitioners held obligations some of which had been issued at a discount and others of which had been issued at a premium and had failed to make the election to amortize the premium, the Government would be in the strange position of contending that under the 1939 Code premium is not an income item but affects capital gain or loss, whereas discount as to which there is no applicable statutory provision—not even elective—is an income item and does not affect capital gain or loss.

The Court below did not attempt to reconcile its decision with the holdings of this Court as regards debt premium.

D. The Court below gave considerable weight to the argument that discount must be interest because it is compensation for the use of money. Equating compensation for the use of money and interest in this fashion is not sustained by the legislative history and the precedent in this Court which have already been described. As recently as last year Congress again recognized that compensation for the use of money is not the same as interest or an income item in the absence of special legislation. The Revenue Act of 1964 added Section 483 to the 1954 Code so as to establish an interest element in sales transactions calling for deferred payments but without expressed interest. Prior to this amendment of the Code no part of such deferred payments would have been taxed as interest even if a portion of the payments may have represented compensation for the use of money.

II.

In 1952 and for more than 30 years prior thereto the consistent administrative practice and interpretation of the 1939 Code and prior Revenue laws was that discount on pri-

vate securities was not interest but a capital item taxable as capital gain when realized by sale or exchange. Such questions as to discount as may have existed during this period were deemed answered when on December 25, 1944 the Commissioner of Internal Revenue published his Acquiescence in *Caulkins* v. *Commissioner,* 1 T. C. 656 (1943), aff'd 144 F. 2d 482 (6th Cir., 1944). This case involved the status of discount realized upon retirement of a security in registered form, which discount from the security itself was obviously compensation for the use of money in lieu of interest. Both the Tax Court and the Circuit Court held that profit attributable to the discount was not interest but capital gain.

The Acquiescence and the statute, so far as is here pertinent, continued undisturbed through five major legislative overhauls that took place between the date of the Acquiescence and the initiation of the transactions before this Court. Accordingly, in 1952 petitioners believed that the *Caulkins* Acquiescence represented the official interpretation of the statute as regards discount. In March 1955, the Government in a Revenue Ruling 55-136, 1955-1 Cum. Bull. 213, announced that the *Caulkins* case had been wrongly decided and that the Acquiescence was withdrawn. The Government is applying this change of position and interpretation retroactively to 1952.

Petitioners acted in reliance on the Treasury position as existing in 1952 and have been harmed by the retroactive application of the changed position regarding discount. The Court below held that petitioners could not complain because the Government may always correct a mistake of law and apply such correction with retroactive effect. The authority cited is the decision of this Court in *Automobile Club of Michigan* v. *Commissioner,* 353 U. S. 180 (1957).

It is true that this Court held in the *Automobile Club of of Michigan* case that Section 3791(b) of the 1939 Code give the Government the power to determine whether a ruling

should be applied without retroactive effect and therefore confirms the power to apply rulings retroactively, and that the Government may correct a mistake of law. However, the *Automobile Club of Michigan* case not only represents the most recent consideration by this Court of the subject matter but also recognizes that the Government is under an obligation properly to apply the power given it in Section 3791(b); otherwise, an abuse of discretion will exist. Whether or not there has been a proper exercise of the power will depend on the "circumstances" of the case. 353 U. S. at page 184.

This Court's delineation of "circumstances" which sustain retroactive application of a change of position or correction is therefore of major significance to the determination of this issue. The standards which were thus accepted provide a basis for determining whether the Government has acted properly when applying to the year 1952 the position taken by it in subsequent years.

The Automobile Club of Michigan had complained that, although its exemption rulings had been revoked in 1945, the Treasury was assessing tax for 1943 and 1944. However, this Court pointed out that an Internal Revenue Service General Counsel's Memorandum had been published in 1943 which had made clear to all clubs such as the Automobile Club of Michigan that tax exemptions previously allowed were in error. Accordingly, the Automobile Club of Michigan was on notice in 1943 that it was no longer deemed exempt and accordingly should have anticipated a tax liability for that year and thereafter. This position thus taken in 1943 had been uniformly applied. All automobile clubs were similarly treated; there was no discrimination in favor of one club as against another. The exempt status of all such clubs had been revoked as of 1943 and taxes were assessed as against all clubs commencing with that year. Under such "circumstances" application of the 1945 revocation to 1943 and 1944 was to be upheld.

In this case petitioners had no notice in 1952 of any contemplated change of position. Petitioners could have no knowledge that the *Caulkins* Acquiescence was to be withdrawn and the Treasury practice which it evidenced, abandoned. Moreover, the Automobile Club of Michigan apparently took no steps in 1943 and 1944 by way of choice among available courses of action because of the rulings later revoked, whereas petitioners did acquire the securities in reliance on the Government's position in 1952 as well as prior thereto regarding discount.

The withdrawal of the *Caulkins* Acquiescence and the change of position was not retroactively applied as regards persons who had purchased Accumulative Installment Certificates from Investors Services (the particular security involved in the *Caulkins* case) during the period December 25, 1944, the date of the *Caulkins* Acquiescence, and the date when the Acquiescence was withdrawn. At the same time it was acknowledged by the Treasury that there was no basis to distinguish the discount in the *Caulkins* type security from the discount involved ordinarily in any obligation. Accordingly, applying the principle established in *Automobile Club of Michigan,* there is here no dealing with all taxpayers "upon the same basis" which that case emphasizes as an appropriate standard. 353 U. S. at page 186. Without reason taxpayers who in this period purchased a particular discount security are favored against taxpayers who like petitioners in the same period acquired other discount securities.

In *Automobile Club of Michigan,* the "circumstances" showed no abuse of discretion. However, the Federal courts in following *Automobile Club of Michigan* are to examine the circumstances of the retroactive application of a change of position and then determine whether there has been an abuse of discretion or a proper exercise of power. So far as can be ascertained from the opinion below, the Second Circuit made no such examination and

nevertheless sustained the manner in which the change of position was retroactively applied to 1952.

The Government apparently believes that it may retroactively change its position in a non-uniform and discriminatory manner. Such a position, if upheld, will greatly impede business planning. Administrative law cannot approve administrative actions arbitrarily and selectively imposing tax consequences officially disclaimed and therefore not foreseeable when the transactions were undertaken. Taxpayers and their advisors should be permitted and encouraged to rely on published pronouncements of the Government and to be certain that they will be treated no less favorably than any other taxpayer similarly situated.

POINT I

Under the 1939 Internal Revenue Code original issue discount is when realized upon sale taxable as capital gain unless otherwise specifically provided.

A. The Applicable Sections of the 1939 Code Unlike the 1954 Code Provide Capital Gain Treatment for Discount.

A capital gain is realized pursuant to the 1939 Code when a capital asset is sold or exchanged for a price in excess of its cost. Section 111(a).[1] Capital assets are defined in Section 117(a) and based upon the statute, the securities here involved were capital assets. It is also undisputed that the securities were sold and that a price in excess of cost was received and that the gain was reported as a capital gain.

Such statutory provisions as exist in the 1939 Code uphold petitioners' reporting of the transactions before this Court. And yet the Court below denies petition-

---

[1] All Internal Revenue Code references are to the 1939 Code unless otherwise stated.

ers' capital gain treatment on the ground that original issue discount is always an income item in the nature of interest and when realized must remain ordinary income and not capital gain (R. 47). No statutory provision is or could have been cited to support the holdings.

It is not until 1954 that a statutory provision (Section 1232 of the 1954 Code) was enacted to change the general rule and classify discount as an income item. This provision is by its terms applicable only to securities issued after December 31, 1954.

The Court below was aware that in the 1939 Code there was no provision comparable to Section 1232 of the 1954 Code. The difference between the two Codes was explained on the ground that the 1954 Code only clarified the law and did not revise existing law (R. 49).

However, the addition to the 1954 Code of a special section not found in the 1939 Code which, like the decision below, classifies discount as an income item, at the very least persuasively indicates that different tax results exist under the two Codes. The explanation of the Court below should therefore be accepted only if clearly supported, and this is not the case.

As is fully developed hereafter, this explanation is contradicted by the understanding and intent of Congress in connection with the Revenue laws prior to the 1954 Code, that discount, unless specific legislation to the contrary exists, is a capital item. Under Section 1232 of the 1954 Code gain attributable to discount is not termed interest but placed in the category of ordinary income through classification as gain from the sale of a non-capital asset. Furthermore, unlike the decision below, the 1954 Code does not remove all discount from the capital item classification. If the amount thereof does not exceed the limits placed in section 1232 (b)(1) of the 1954 Code, then discount when realized remains capital gain.

It is also significant that the Second Circuit subsequently departed from the conclusion that the 1954 Code merely clarified existing law. In *Lubin* v. *Commissioner*, 335 F. 2d 209 (2nd Cir., 1964) it was held that under the facts in that case the gain attributable to discount realized on retirement of certain registered obligations was not interest but a capital item and therefore taxable as capital gain. The Court, however, stated that this result could exist only under the 1939 Code and that had the 1954 Code provisions been applicable, the discount when realized would have constituted ordinary income (335 F. 2d at p. 212, n. 3). Accordingly, there is recognition in the *Lubin* case that the 1954 Code did revise previously existing law.

B. Legislative History Demonstrates That Congress Understood and Intended That Under the 1939 Code Discount in the Circumstances of This Case is a Capital Item Taxable as Capital Gain When Realized by Sale.

The history of Congressional treatment of original issue discount for tax purposes is replete with evidence that Congress has been fully cognizant of the relationship between discount and interest and has repeatedly made a deliberate distinction in the tax treatment of each. This is found in the several occasions when Congress considered the status of original issue discount prior to, as well as at the time of, the enactment of the 1954 Code. In each instance Congress has recognized that original issue discount is a capital item taxable as capital gain when realized unless Congress has legislated to the contrary. This recognition exists both in express Congressional statements as well as in the fact that there has been specific legislation whenever Congress concluded that in a particular situation capital gain treatment for discount was not warranted and should be replaced by ordinary income treatment.

Congressional understanding that discount is a capital item is found in the course of the consideration given by Congress in 1929 to the authorization of the issue of non-interest-bearing United States discount obligations. The Treasury had proposed that any gain from the sale of these obligations be exempt from tax. It is evident from the Congressional Record that opposition developed because the Senate was of the opinion that discount when realized is capital gain and did not wish to set any precedent which would exempt any capital gain from tax even if arising from Government obligations the interest on which was exempt from tax. June 4, 1929, Congressional Record, Senate, pp. 2319-2333. It is also apparent from the debate that the Senate Finance Committee had been advised by the Treasury that under its interpretation of the statutes discount when realized was a capital item. Senator Couzens of Montana stated:

> "The Undersecretary of the Treasury stated before the Finance Committee that the same identical bills of indebtedness when traded in commerce, are subject to a profit tax. When a bill is traded in commerce, an acceptance, or what not, if there is a capital gain, it is taxed." June 4, 1929, Congressional Record, Senate, p. 2330."

During the same debate, Senator Reed of Pennsylvania expressed the prevailing Congressional opinion of the status of discount as follows:

> "Mr. President, it seems to me that these questions have brought the issue down to the real point. What actually happens in the case of the transaction described by the Senator from Montana is that a negotiable instrument [a discount obligation] is bought at one price, and subsequently sold at another; and the profit, taken in connection with the time the bill is held, is capital gain which is the equivalent of interest on that money." June 4, 1929, Congressional Record, p. 2331.

In other words, it is recognized that discount though compensation for the use of money is when realized on sale taxable as capital gain and not as interest.

Congress resolved the problem before it in 1929 by enacting a statute, presently Section 754(b) of Title 31 U.S.C., which specifically provides that discount on non-interest-bearing U. S. obligations is interest. In this manner, the discount on the newly-authorized United States obligations was made subject to the exemption from tax then applicable to interest paid on obligations of the United States.

The legislative developments in connection with the Revenue Act of 1938 reiterate Congressional understanding that discount absent specific legislation is a capital item. Congress at that time was investigating a suggested change in the tax laws to eliminate the taxation of capital gains. The Subcommittee of the Committee on Ways and Means which was appointed to consider the proposal recommended that no such change be made. A primary reason advanced by the Committee for its recommendation against exemption of capital gains from taxation was that it would permit discount like other capital gains to escape taxation. The report of this Subcommittee shows that the treatment of discount as a capital gain item was known to the Congress and accepted by it as well as was the relationship between discount and interest and the existence of a deliberate difference in tax status:

> "It is important also to emphasize that there is no clean separation in practice, between capital gains and ordinary income; and that the complete exemption of capital gains from income taxes might well stimulate the conversion of other types of income into the form of capital gains. For instance, mortgages, land contracts, etc., are frequently sold at substantial discounts. From a statutory standpoint, the difference between the principal amount and the purchase price is regarded as a capital gain; but from an economic standpoint the discount is

merely the means whereby the effective annual yield of the instrument is raised from, say, 6 percent to 12 or 15 percent. A bond purchased at a premium results in a capital loss when redeemed at par, and a bond purchased at a discount, is a capital gain. Yet it is the everyday practice in investment circles to quote both these types of bonds in terms of their effective yields to maturity or call date. Consequently, elaborate provisions in the statute, the effective administration of which would be impossible or extremely difficult, would be necessary, if the income tax were removed from capital gains, in order to prevent widespread avoidance of the income-tax burden through manipulation of ordinary income into the guise of capital gain." Report of Subcommittee of Committee on Ways and Means, 75th Cong. 3rd Sess. dated January 14, 1938. Reported in Hearings on H. R. 9682, 75th Cong. 3rd Sess., p. 38.

The enactment of the 1954 Code and the special classification in Section 1232 thereof of discount as an income item was accompanied with re-affirmation of the capital gains status of discount under prior law. The report of the House Ways and Means Committee in connection with the 1954 Code stated:

> "Under existing law any gain realized from a corporate or Government bond in registered form or with coupons attached is treated as a capital gain either if the bond is held to retirement or it is sold or exchanged. Part or all of this gain, however, may represent discount on original issue which is a form of interest income and in fact is deductible as an interest payment by the issuing corporation.
>
> "Effective with respect to bonds issued after December 31st, 1954, the committee bill provides that any gain realized by the holder of a bond attributable to the original issue discount will be taxed as ordinary income * * *." H. Rep. No. 1337, 83rd Cong., 2d Sess. p. 83 (3 U. S. C. Cong. & Adm. News (1954) 4017, 4110)

Legislative understanding is clearly reflected in the special actions taken by the Congress whenever it was desired to make of discount an income item and subject to ordinary income treatment. There are accordingly, many instances of statutory enactments prior to 1954 which would have been superfluous had it been the understanding and intention of Congress that original issue discount is always an income item rather than a capital item. Instances of such statutory enactments regarding discount include the following sections of the 1939 Code:

Section 117(a)(1)(D)—making discount on the securities there enumerated an income item by excluding these securities from the definition of capital assets.

Section 42(b)—allowing an election to report annually increases in the value of discount obligations limited, however, to the type specified therein.[2]

Section 42(c)—postponing realization of income from short-term Government discount obligations until disposition.

Section 201(e)—requiring accrual of bond discount and amortization of bond premium on all obligations but only for life insurance companies.

Section 207(d)—requiring accrual and amortization respectively of discount and premium on all obligations but only for certain mutual insurance companies.

[2] U. S. Savings Bonds are of course the typical obligation covered by this section. It is therefore of considerable interest that in 1948 there was introduced in Congress H. R. 6999 the avowed purpose of which was to provide capital gains treatment for United States obligations issued at a discount comparable to the capital gains treatment available for private securities issued at a discount. 26 Taxes 775 (1948).

Discount in principle is of course no different for present purposes than premium.[3] Both are equally concerned with compensation for the use of money and have been so recognized by this Court. *Old Colony R. Co.* v. *Commissioner*, 284 U. S. 552, 558-9 (1932). Yet it required the enactment of a special statute (Section 125 of the 1939 Code) to permit the amortization of premium in order to achieve a "true" interest yield; and even this is permitted only on an elective basis.

There is yet further proof of Congressional understanding that discount is a capital item unless contrary specific legislation exists. For more than 30 years prior to the 1954 Code it had been the practice of the Treasury (and the Revenue laws were so interpreted)[4] to treat original issue discount as a capital item and not as interest unless the Revenue laws provided otherwise.[5] During this period there are many statutory re-enactments, including the 1939 Code. In fact, between December 25, 1944 the date of the Acquiescence in *Caulkins* v. *Commissioner*, I. T. C. 656 aff'd 144 F. 2d 482 (6th Cir., 1944)[6] and January 1, 1952, there are five statutory overhauls of major significance,[7] and at no time did Congress seek to change the rule

[3] The relationship between premium and discount and the holdings of this Court in connection with premium are more fully discussed at pages 21-24, *infra*.

[4] Pages 26-29, *infra*.

[5] An exception to the practice existed as regards discount on state and municipal securities. G. C. M. 21890, 1940-1 Cum. Bull. 85. However, the considerations connected with state and municipal obligations where there are constitutional implications are completely different from those existing with regard to private securities.

[6] The *Caulkins* case held that discount when realized on retirement of a registered obligation is a capital gain and the Government Acquiesced. The case and the Acquiescence are discussed at pages 26-29, *infra*.

[7] The Revenue Acts of 1945, 1948, 1950 and 1951 and the Technical Changes Act of 1949.

governing the tax treatment of discount (nor did the Treasury apparently request any change). Under such circumstances, this Court has repeatedly held that not only is there a clear demonstration of Congressional intent, but the equivalent of Congressional approval and an express statutory enactment:

Thus, in *Helvering* v. *Winmill*, 305 U. S. 79 (1938) this Court stated (p. 83):

> "Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially re-enacted statutes, are deemed to have received congressional approval and have the effect of law."[8]

With one exception, the legislative history which has been set forth, has apparently not been taken into consideration or given any weight by the Courts which have recently reviewed the status of discount under the 1939 Code. The exception is found in the opinion of Judge Kalbfleisch in *Midland-Ross Corporation* v. *United States*, 214 F. Supp. 631 (N. D. Ohio, 1963), aff'd 335 F. 2d 561 (6th Cir., 1964),[9] and he concluded that discount is a capital item unless special legislation to the contrary exists.

The legislative history to which the Court below refers to demonstrate Congressional intent is limited to the report of the Senate Finance Committee in connection with Section 1232 of the 1954 Code. This report is cited to show that the 1954 Code merely clarified existing law as regards discount without changing it because it is stated in the Report that "there is some uncertainty" as to the status of discount when realized and that effective with respect to obligations issued after December 31, 1954 the uncer-

---

[8] See also *Massachusetts Mutual Life Insurance Co.* v. *United States*, 288 U. S. 269, 273 (1933); *Brewster* v. *Gage*, 280 U. S. 327, 337 (1930).

[9] In its *per curiam* affirmance the Sixth Circuit termed the opinion of Judge Kalbfleisch "comprehensive."

tainty is removed by taxing the gain attributable to original issue discount as ordinary income. S. Rep. No. 1622, 83rd Cong., 2d Sess., p. 112 (3 U. S. C. Cong. & Adm. News (1954) 4621, 4745).

The Senate Report cannot dispose of the unbroken chain of legislative history, including the House Ways and Means Committee Report in connection with the same statute, that discount under the 1939 Code was not an income item. The Senate Report does not state that the ordinary income treatment in the 1954 Code is declarative of existing law but on the contrary expressly disclaims retroactive intent. Furthermore, the references to show "some" uncertainty demonstrate that the Committee was not fully informed. For this purpose the Report compares *Commissioner* v. *Caulkins* (without mentioning the Acquiescence) and I. T. 3486 1941-2 Cum. Bull. 76. There is no basis for this comparison. *Commissioner* v. *Caulkins* clearly held that discount is a capital item taxable as capital gain when realized. I. T. 3486 merely pointed out that since original issue discount on certain United States obligations was expressly treated as interest by statute (now Section 754(b) Title 31 U. S. C.) the elimination in 1941 of tax exemption for interest on United States securities was applicable to any such discount as well as to expressed interest. A ruling issued under a specific statute which was required and therefore enacted in order to treat discount as interest supports the *Caulkins* treatment of discount as a capital item rather than throws doubt upon it, and by no means creates uncertainty.

Legislative intent is certainly not demonstrated by a Congressional Report which refers to "some" doubt and which is contradicted by the contemporaneous report in the other legislative chamber. Legislative intent can be found in the long-standing and consistent legislative history which directly and unequivocally classifies discount as a capital gain when realized by sale or exchange.

C. The Holding Below That Discount is an Income Item Taxable as Interest Because it is Compensation for the Use of Money is in Conflict With the Decisions of This Court Concerning Bond Premium and Cannot Be Sustained.

Prior to the amendment of the 1939 Code which added Section 125 the Government took the position that bond premium could not be amortized against income. This position was taken despite the fact that premium directly affects the amount of compensation received for the use of money; to the extent that the lender pays a premium the effective interest rate received by him is reduced. Since the Government is contending that discount is an income item in the nature of interest because it represents compensation for the use of money, then it should have recognized that premium is likewise a part of the determination of the amount of compensation received for the use of money and therefore always an income item. Had the statute not been changed to permit premium amortization against income, the Government would now be arguing inconsistently that interest income is realized from discount although unaffected by premium. Even at present if a taxpayer fails to make the election under Section 171 of the 1954 Code (formerly Section 125 of the 1939 Code), the Government would contend that as regards this taxpayer premium remains a capital item.

The Government's position that premium is a capital item, contrary to its position here as regards discount, was upheld by this Court in *New York Life Insurance Co.* v. *Edwards*, 271 U. S. 109 (1926). This holding should be accepted as recognizing that although an item may have a direct relationship with compensation for the use of money, it is not necessarily an income item.

In *Old Colony R. Co.* v. *Commissioner*, *supra*, this Court again considered the relationship between interest, premium and discount. The question before the Court

was whether in determining the interest deduction, premium should be applied as a pro rata offset. In holding that the premium in that case need not be thus applied, this Court stated that the concept of an imputed or "effective" interest rate has no place in tax law. The Court recognized "that the actual return to one who pays a premium is less than the nominal interest carried by the bond and to one who buys it a discount is greater than such nominal rate." 284 U. S. at 558. Although "effective rate" may have a place in accounting, it is not relevant for tax purposes. Had Congress intended to incorporate such concepts into the Revenue law, it would have so provided.[10]

The Government's position in this case is accordingly based on theories which this Court has rejected. Discount may be compensation for the use of money and part of the financial determination of the effective rate or yield, but it is not by reason thereof an income item. The law as settled by this Court in the cases dealing with bond premium cannot be reconciled with the decision of the Court below and it is significant that the Court attempted no such reconciliation;[11] so long as specific legislation is required to make of

---

[10] There are more recent decisions of this Court which follow the same basic approach: *Commissioner* v. *Korrell,* 339 U. S. 619 (1950) (premium paid for a conversion privilege could be amortized under Section 125 prior to amendment even though not economically concerned with the use of money); *Hanover Bank* v. *Commissioner,* 369 U. S. 672 (1962) (bond premium amortization based on special call price which probably would not be used was permitted although the effective interest rate was thereby distorted).

[11] The Second Circuit did refer to the *Old Colony R. Co.* case in *Lubin* v. *Commissioner,* 335 F. 2d at 213 when deciding that the discount in that case was a capital item. The *Old Colony R. Co.* case is cited as authority for the rule that not all discount is interest since the "term 'interest' when used by Congress is to be construed according to 'the usual, ordinary, and everyday meaning of the term' and not according to 'some esoteric concept derived from subtle and theoretic analysis'."

premium an income item, as this Court held, then also special legislation is required to make of discount an income item.

The foregoing also demonstrates the fallacy of the Government's argument accepted by the Court below, that a one-year note for $10,600 issued for $10,000 must in tax effect be identical with a $10,000 note of like duration issued with 6% stated interest. This example, at most, reiterates that discount is compensation for the use of money. In the light of the cases in the Court dealing with bond premium the example has no meaning for tax purposes. Otherwise, even without special legislation the tax result to the holder of a one-year obligation for $10,000 should be the same regardless of whether it was issued at a $300 premium for $10,300 with stated interest at 6% or for par with stated interest of 3%.

The weakness of this Government argument is also demonstrated by recent legislative history in connection with the Revenue Act of 1964. Recognizing that an interest rate cannot be imputed or made effective where none is expressed, the Courts have held that if a capital asset is sold for $11,000 payable in 2 years without interest, the entire gain was capital even though were the price stated as $10,000 payable in 2 years with interest at the rate of 5% per annum the capital gain is to be based on the $10,000 price and the 5% is to be taxed as interest.[12] It required the enactment of a special statute so that the element of compensation for the use of money which was clearly present could be taxed as interest. Section 483 of the 1954 Code as added by Section 224 of the 1964 Revenue Act. The report

[12] In *Kingsford Co.* v. *Commissioner,* 41 T. C. 646 (1964) the agreement of sale specifically stated that the price included both principal and interest and yet the Tax Court refused to find taxable interest because no interest rate had been expressed. And the Treasury has very recently accepted this decision as correct by its Acquiescence in the case. 1964 IRB No. 51 at page 6.

of the House Ways and Means Committee states the prior law and the reason for the change:

> "Your Committee sees no reason for not reporting amounts as interest income merely because the seller and purchaser did not specifically provide for interest payments. This treats taxpayers differently in what are essentially the same circumstances merely on the grounds of the names assigned to the payments. In the case of depreciable property this may convert what is in reality ordinary interest income into capital gain to the seller. At the same time the purchaser can still recoup the amount as a deduction against ordinary income through depreciation deductions. Even where the property involved is a non-depreciable capital asset, the difference in tax bracket of the seller and buyer may make a distortion of the treatment of the payments advantageous from a tax standpoint * * *." H. Rep. No. 749, 88th Cong., 1st Sess. p. 72.

D. The Authorities Cited by the Court Below and by the Other Courts Which Have Reached the Same Result Are Not in Point.

The question before this Court has been considered by other constitutional courts beside the Second Circuit.[13] Apart from the decision of the Sixth Circuit in *Midland-Ross Corporation* v. *United States*, 214 F. Supp. 631 (N. D. Ohio, 1963), aff'd 335 F. 2d 561 (6th Cir., 1964), all have reached results adverse to the taxpayers. As authority, however, each such Court apart from citing a prior decision in another Court on the question relies on authorities that are not in point and in addition does not discuss the relevant legislative history.

[13] *Commissioner* v. *Morgan*, 272 F. 2d 936 (9th Cir., 1959); *Rosen* v. *United States*, 288 F. 2d 658 (3rd Cir., 1961); *United States* v. *Harrison*, 304 F. 2d 835 (5th Cir., 1962), cert. denied, 372 U. S. 934 (1963); *Pattiz* v. *United States*, 311 F. 2d 947 (Ct. Cl., 1963); *Real Estate Investment Trust of America* v. *Commissioner*, 334 F. 2d 986 (1st Cir., 1964).

The Circuit Court decisions repeatedly cited are *Jaglom* v. *Commissioner,* 303 F. 2d 847 (2nd Cir. 1962) and *Fisher* v. *Commissioner,* 209 F. 2d 513 (6th Cir.) cert. denied 347 U. S. 1014 (1954). Both of these cases are concerned with taxation of expressed interest when realized upon a sale and not with discount and can be material only if the conclusion is assumed that discount is an income item in the nature of interest—the very point at issue here.

The holdings of this Court frequently cited are *Commissioner* v. *P. G. Lake, Inc.,* 356 U. S. 260 (1957), *Commissioner* v. *Horst,* 311 U. S. 122 (1940), *Deputy* v. *DuPont,* 308 U. S. 448 (1940). These cases likewise are not relevant to the issue. The *Lake* and *Horst* cases are concerned with the disposition only of a right to income apart from the capital asset and conclude that the realization under such circumstances cannot be capital. There has been no comparable retention here. *Deputy* v. *DuPont* involved the status of amounts required to be paid the lender of stock in connection with a short sale measured by dividends paid during the period of the loan. This Court held that such payment was not interest for tax purposes and defines interest as compensation for the use of money. That is not, however, the issue in this case.[14]

[14] In *Lubin* v. *Commissioner* the Second Circuit characterized the definition of interest in *Deputy* v. *DuPont* as "while useful as a starting point [it] is not dispositive of the issue before us nor can it be." (335 F. 2d at p. 213.)

POINT II

The Government should not be permitted retroactively to change on a discriminatory basis its position as regards original issue discount, which position is evidenced by the Acquiescence in *Caulkins* v. *Commissioner*, to the detriment of the petitioners who relied on such position.

A. During 1952 and for More Than 30 Years Prior Thereto the Government's Position Was That Original Issue Discount Was a Capital Item and When Realized by Sale or Exchange Taxable as Capital Gain.

In 1944 the Sixth Circuit affirmed the Tax Court and held that discount when realized by retirement of a registered obligation[15] is a capital item and not an income item. *Caulkins* v. *Commissioner*, 1 T. C. 656 (1943), aff'd 144 F. 2d 482 (6th Cir., 1944). The Treasury promptly acquiesced 1944 C. B. 5 (1944).

The Acquiescence was no surprise. Commencing in 1920 and without interruption the Treasury, as the occasion was presented for ruling, took the position that original issue discount on private securities was a capital item. It is set forth basically as early as 1920 in O. 1024, 2 Cum. Bull. 189 (1920). This ruling holds that original issue discount is not interest and therefore not subject to the withholding provisions when the security is owned by a non-resident alien taxpayer. In the ruling itself it is recognized that the discount is "compensation for the use of money and as such resembles interest" but it is ruled "such discount is not 'interest' * * *." In the same year in O. D. 475, 2 Cum. Bull. 211 (1920) discount as well as premium are held capital items:

> "Amortization of premium or discount on bonds as contemplated in Articles 544, 563 and 848, Regu-

[15] Pursuant to section 117(f) retirement of a registered obligation is the equivalent of the exchange of that obligation.

> lations 45 (dealing with the debtor's tax treatment), is not permissible in the case of the purchaser of bonds. The purchase price of the bond, even though different from par represents the investment. When the bonds mature or are sold the basis for determining the gain or loss is their purchase price, or their fair market value as at March 1, 1913, if acquired prior to that date."

In 1922 the position taken in O. 1024, *supra*, was reaffirmed in I. T. 1398, I-2 Cum. Bull. 149 (1922).

In 1927 the Treasury argued before the Tax Court, and was upheld, that bond discount as well as bond premium were capital items to be reflected only in the determination of the amount of gain or loss realized upon the disposition of the securities involved. *Corn Exchange Bank* v. *Commission*, 6 B.T.A. 158 (1927).

Even the institution of the Caulkins litigation represented no break in the Government's thinking. The primary point argued before the Tax Court in this case was that the securities at issue were not eligible on retirement for the capital gain treatment provided in Section 117(f), that these securities were not in proper form and that therefore the increment was ordinary income taxable as interest. In fact, the Government attorney admitted in the Tax Court that in the absence of specific legislation even the increment on United States savings bonds issued at a discount would have been capital gain (1 T. C. 656, 662).

The significance of the Acquiescence in the Caulkins case cannot be over-emphasized. To the tax practitioner and the businessman an Acquiescence is a most important expression of official interpretation and position. Added to the prior consistent Government pronouncements, the Caulkins Acquiescence was surely deemed dispositive of any question about the status of discount. The impact of this Acquiescence was all the greater because the Cir-

cuit Court, in its opinion in the *Caulkins* case, expressed reservations about the result and invited legislative review of the issue.[16]

In addition, in the years following the Caulkins Acquiescence, the Treasury apparently continued to issue private rulings consistent with its prior practice and the Acquiescence.[17] Almost contemporaneously with the initiation of the transactions before the Court, the Treasury again on March 12, 1952 ruled that original issue discount is not an income item in the nature of interest and any tax liability with respect thereto was as a capital gain.[18]

On July 6, 1953, shortly before public consideration of the 1954 Code commenced, the Commissioner published Revenue Revuling 119 (1953-2 Cum. Bull. 95), the so-called Israeli Bond Ruling.[19] The ruling recognizes that the State

---

[16] Text writers during the period following the *Caulkins* case had little question but that discount was a capital item in the absence of legislation and that such was the accepted government view. 4 Mertens, Law of Federal Income Taxation, Sec. 23, p. 162 n. 31, Paton, Advanced Accounting 196 (1941); Accountants Handbook, 483 (3rd Ed. 1943); Newlove, Intermediate Accounting, 205 (1939 Ed.); Lawrence, Bond Discount Treatment under the 1942 Revenue Act, 21 Taxes 61 (1943).

[17] 26 Taxes 775 (1948).

[18] 5 CCH 1952 Stand. Fed. Tax Rep. par. 6161. The application for ruling at 5 CCH 1952 Stand. Fed. Tax Rep. par. 6284 makes it clear that the securities involved had been issued at a discount. The March 12, 1952 ruling holds that there need be no withholding despite discount if the securities are held by a non-resident alien since discount is not interest but points out that by reason of Section 211(a)(1)(B) as amended by the 1950 Revenue Act, gain on sale prior to maturity may be subject to capital gains taxation.

[19] In the years between December 25, 1944, the date of the Caulkins Acquiescence, and July 9, 1953, the date of the Israeli bond ruling (Revenue Ruling 119, 1953-2 Cum. Bull. 95), the Government in litigation before the Tax Court raised the question of the treatment of discount. In each instance, however, the question was not on the ground that discount was an income item but either on the ground

of Israel bonds are similar to United States Savings Bonds and states that there is no basis to distinguish or tax differently the discount involved in the Israeli bond from that of the United States bond. The *Caulkins* case and the Acquiescence are referred to and are henceforth to be limited to what was decided under the facts of that case. The Caulkins Acquiescence is, however, not withdrawn.

The present Treasury position as regards discount under the 1939 Code was published on March 11, 1955 in Revenue Ruling 55-136 (1955-1 Cum. Bull. 213). In this ruling the Caulkins Acquiescence is withdrawn and it is stated that discount is when realized an income item.

The importance to taxpayers of Treasury practice and interpretation can hardly be overstressed. The tax statutes are complex and they affect materially most transactions. Petitioners purchased the securities here involved in reliance on the Government's position regarding discount as it existed in 1952. In like fashion numerous transactions are planned and consummated in the light of existing Treasury interpretations of the tax laws. If it is held that Treasury practice and published rulings of long standing may be given no weight, substantial harm and disruption will ensue.

---

that the obligations were not in registered form (*Timkin* v. *Commissioner,* 6 T. C. 483 (1946), Acq. 1946-2 Cum. Bull. 5; *Carl Oestreicher, Trustee* v. *Commissioner,* 20 T. C. 12 (1953), Acq. 1953-2 Cum. Bull. 5) or on the ground that the transaction did not constitute a sale or exchange within the meaning of Section 117(f) (*Timken* v. *Commissioner, supra; Klein* v. *Commissioner,* 15 T. C. 26 (1950), Acq. 1950-2 Cum. Bull. 3; *Avery* v. *Commissioner,* 13 T. C. 351 (1949), Acq. 1950-1 Cum. Bull. 1).

B. The Government Changed its Position as Regards Original Issue Discount and Withdrew the Caulkins Acquiescence Subsequent to the Acquisition and Sale of the Securities Here Involved and Under Circumstances of This Case Should Not Be Permitted to Apply Such Change of Position and Withdrawal of Acquiescence Retroactively Against Petitioners Who Had Acted in Reliance on the Prior Position and the Acquiescence.

The Government first withdrew the Caulkins Acquiescence in 1955. Petitioners purchased and sold the securities in 1952. These securities were acquired because petitioners understood that it was the Government's position at that time and for many years prior thereto (as evidenced in the Caulkins Acquiescence) that discount was when realized a capital and not an income item.

Acquiescences are published by the Government in the Cumulative Bulletin, an official publication of the Treasury Department. In 1952 that part of the Cumulative Bulletin which contains Acquiescences stated:

> "In order that taxpayers and the general public may be informed whether the Commissioner has acquiesced in a decision of The Tax Court of the United States disallowing a deficiency in tax determined by the Commissioner to be due, announcement will be made in the Internal Revenue Bulletin at the earliest practicable date. (No announcements are made in the Bulletin with respect to memorandum opinions of the Tax Court.) Notice that the Commissioner has acquiesced or nonacquiesced in a decision of the Tax Court relates only to the issue or issues decided adversely to the Government. Decisions so acquiesced in should be relied upon by officers and employees of the Bureau of Internal Revenue as precedents in the disposition of other cases."

It is significant that the reference is to the "issue or issues" decided in the case which has been acquiesced. Whether or not the facts are in every respect identical is not

material. It is sufficient if the issue which could be involved in a contemplated transaction is the same as that involved in an Acquiescence. By Acquiescence in the Caulkins decision the Government gave its answer to the issue regarding the status of discount. The issue which could be involved in the securities before this Court was the same as in the Caulkins case: In the event of sale or exchange of the securities would the discount at which they were issued constitute a capital item or an income item. This issue was deemed answered, and petitioners so believed, by the Caulkins Acquiescence.

Nevertheless, after the initiation and completion of the transactions before this Court the Government changed its position and is now asking to apply that change of position retroactively as against petitioners who had acted in good faith and without any prior notice of a change of position impending or consummated.

The Second Circuit allows the retroactive application of the change of position on the ground that " 'the doctrine of equitable estoppel is not a bar to the correction by the Commissioner of a mistake of law' *Automobile Club of Michigan* v. *Commissioner,* 353 U. S. 180, 183 (1957)" (R. 49). The Court also observes that it would be "unduly harsh" to hold that if the Commissioner of Internal Revenue misinterprets the law, the Government is forever barred from collecting the taxes due (R. 49).[20]

However, this Court has recognized in *Automobile Club of Michigan* that whether retroactive application of a cor-

[20] The question of reliance on the Caulkins Acquiescence and the propriety of application of the Government's change of position was considered by two other Circuit Courts. In *Commissioner* v. *Morgan,* 272 F. 2d 936 (9th Cir., 1960) the Court observed that the taxpayers were not prejudiced since the securities there involved had been purchased well before the *Caulkins* decision and the Acquiescence. In *Rosen* v. *United States,* 288 F. 2d 658 (3rd Cir., 1961), the Court likewise observed that the taxpayers had no basis for complaint because of the change of position since the securities there involved had been acquired before 1944.

rection or of a change of position is to be sustained, depends on the "circumstances of the case" (353 U. S. at p. 184). It is pointed out that the Commissioner has the power under Section 3791(b) to determine whether any ruling should be applied without retroactive effect and that circumstances may exist where, if this power is not exercised, there will be an abuse of discretion, in which event retroactive application will not be upheld.[21]

It is therefore material to examine the facts in *Automobile Club of Michigan* and compare them with the facts in this case. This examination and comparison demonstrates that, whereas there was no abuse of power when the correction in that case was applied retroactively, the "circumstances" of this case are significantly different.[22]

In 1934 and again in 1938 the Commissioner of Internal Revenue had ruled that the Automobile Club of Michigan was exempt from Federal income taxes. In 1945 these rulings and the exemption were revoked and the revocation retroactively applied to 1943 and 1944 and deficiencies in taxes assessed for these years. The Automobile Club argued that this retroactive application of a change of position should not be permitted.

However, the revocation of the ruling issued the Automobile Club was the consequence of a Memorandum of the General Counsel of the Internal Revenue Service, which Memorandum interpreted the applicable 1939 Code provi-

---

[21] As an example of an instance where under the circumstances of the case retroactive application of a change of position should not be approved, this Court cited *Lesavoy Foundation* v. *Commissioner*, 238 F. 2d 589 (3rd Cir., 1956).

[22] Following the *Automobile Club* case retroactive application of change of position has not been sustained for example in *City Loan Savings Co.* v. *United States*, 177 F. Supp. 843 (N. D. Ohio, 1959), affirmed 287 F. 2d 612 (6th Cir., 1961); *Schuster* v. *Commissioner*, 312 F. 2d 311 (9th Cir., 1962).

sion. This Memorandum had been published in 1943 and available to all, including the Automobile Club of Michigan, and ruled that clubs such as the Michigan Automobile Club were not entitled to exemption. The Automobile Club of Michigan therefore commencing in 1943 had been on notice that the Commissioner of Internal Revenue had changed his position to correct a mistake. There was no ground for complaint since the change of position was being applied only to years commencing in 1943 and years prior to 1943 were not affected.

On the other hand, in 1952 petitioners believed that discount under the 1939 Code was a capital and not an income item, and this belief was based upon the then position of the Government as evidenced by the Caulkins Acquiescence, which position had existed unchanged for many years. During that year purchase and sale of securities were made in reliance on that belief. There was no warning or statement available at that time to petitioners of a change of position. Subsequently, the Government did change its position and ruled that *Caulkins* was wrongly decided and the Acquiescence should therefore be withdrawn. The new position was then applied to transactions consumated in prior years in reliance on the prior position.

Knowledge of the Government's position and interpretations of the Internal Revenue Code is of course highly significant. However, this becomes meaningless if the Government not only can change its position and interpretations but retroactively apply these changes to transactions which had been consummated in reliance upon the prior position and interpretations.[23] Under such circum-

---

[23] In enacting Section 506 of the Revenue Act of 1934 the predecessor to Section 3791(b) of the 1939 Code, Congress made it clear that the purpose of this Section was to make available to the Government the power to avoid "inequitable results" which can exist when new interpretations are applied "to past transactions which have been closed by taxpayers in reliance upon existing practice * * *." (H. Rep. No. 74, 73rd Cong., 2d Sess., p. 38).

stances the Government attempt to ignore interpretations publicly accepted by it in 1952 as well as for many years prior thereto and to apply contrary interpretations first announced some time later should not be sustained but held to be an abuse of discretion within the contemplation of the decision in *Automobile Club of Michigan*.

C. The Government Should Not Be Permitted to Apply its Change of Position and Withdrawal of Acquiescence in a Manner Which Discriminates Against Petitioners.

The principle that one taxpayer cannot without logical justification be discriminated against in favor of another taxpayer is an integral part of the tax structure. In the words of Mr. Justice Frankfurter concurring in *United States* v. *Kaiser*, 363 U. S. 299, 308 (1960):

> "* * * The Commissioner cannot tax one and not tax another without some rational basis for the difference. And so, assuming the correctness of the principle of 'equality', it can be an independent ground of decision that the Commissioner has been inconsistent, without much concern for whether we should hold as an original matter that the position the Commissioner now seeks to sustain is wrong."

It is therefore not surprising that this Court in the *Automobile Club of Michigan* case stated that application to 1943 and 1944 of the 1945 revocation could be sustained because "circumstances" of the case showed that such change of position had been uniformly applied. The Automobile Club of Michigan had been treated no differently from any other club similarly situated. This Court recognized that if uniform treatment had not existed, discrimination would have resulted and there would have been a

"circumstance" evidencing abuse of the power allowed the Government in Section 3791(b) (353 U. S. at pp. 185-186).[24]

In the light of this Court's reasoning in the *Automobile Club of Michigan* case, the following facts of this case are most relevant: In 1955 the Government announced in Revenue Ruling 55-136 that the *Caulkins* case would no longer be followed, that this case and the Acquiescence therein were erroneous and that a change of position by the Government was necessitated. However, the possible injustice of applying the change of position against those who had relied on the Caulkins Acquiescence was apparently recognized. The 1955 ruling places in a special class those taxpayers who had made acquisitions of discount securities during the period between December 25, 1944 (the date of the Caulkins Acquiescence) and the date of issuance of the 1955 ruling.[25] However, this favored group does not include all purchasers of discount securities in this period but only those who had purchased a certain kind of security from a certain issuer, namely, Accumulative Installment Certificates from the Investors Syndicate. Accordingly, the Government has attempted to be selective and not uniform. Such an attempt cannot be condoned under *Automobile Club of Michigan.*

The difference in treatment might be acceptable if the discount in the securities here involved could be different from the discount in the securities sold by Investors Syndi-

---

[24] In *Brecklein* v. *Bookwalter,* 231 F. Supp. 404 (D. C. Mo. 1964) (appeal pending 8th Cir.) retroactive application of a change of position was not permitted against one taxpayer if not applied as against all taxpayers, and the *Automobile Club of Michigan* case is cited and quoted as "impliedly" supporting the Court's decision. See also *Exchange Parts Co. of Fort Worth* v. *United States,* 279 F. 2d 251 (Ct. Cl., 1960); *Connecticut Railway & Lighting Co.* v. *United States,* 142 F. Supp. 907 (Ct. Cl., 1956).

[25] In Revenue Ruling 56-299, 1956-1 Cum. Bull. 603 this period was shortened to December 31, 1954. It would appear that the reason for the modification is that Section 1232 of the 1954 Code expressly applies to obligations issued after December 31, 1954 and this provision of course makes of discount an income item.

cate. No such basis exists and this has been recognized by the Government. In the same Revenue Ruling 55-136 it is stated that "there is no logical basis in fact or in law to distinguish the discount element in the Accumulative Installment Certificates involved in the Caulkins case from the original discount element involved ordinarily in the issuance of any bonds." (1955-1 Cum. Bull. 213, 214).

As this Court has recognized, the power retroactively to apply a change of position must be properly exercised and cannot be abused. In view of the lack of uniform treatment, for which no justification can exist, there surely is an abuse of discretion under Section 3791(b) which should be corrected.

The Second Circuit to support its conclusion does refer to *Automobile Club of Michigan*. However, the Court apparently made no examination of the "circumstances of the case" since it concluded that retroactive correction is always permissible without regard to the circumstances (R. 49). This conclusion is not supported by the decision of this Court in *Automobile Club of Michigan*. On the contrary, this Court made it clear that retroactive application may constitute an abuse of discretion, and had the Court below followed the standards accepted by this Court, it should not have refused to recognize the validity of petitioners complaint. The "circumstances" emphasized by this Court as permitting retroactive application are not present here.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the judgment of the Court below should be reversed.

Respectfully submitted,

BERNARD E. BRANDES,
SANFORD SAIDEMAN,
Attorneys for Petitioners.

Of Counsel:
STROOCK & STROOCK & LAVAN.

APPENDIX

Internal Revenue Code of 1939

Sec. 42. Period in Which Items of Gross Income Included.

* * *

(b) Noninterest-Bearing Obligations Issued at Discount.—If, in the case of a taxpayer owning any noninterest-bearing obligation issued at a discount and redeemable for fixed amounts increasing at stated intervals or owning an obligation described in paragraph (2) of subsection (d), the increase in the redemption price of such obligation occurring in the taxable year does not (under the method of accounting used in computing his net income) constitute income to him in such year, such taxpayer may, at his election made in his return for any taxable year beginning after December 31, 1940, treat such increase as income received in such taxable year. If any such election is made with respect to any such obligation, it shall apply also to all such obligations owned by the taxpayer at the beginning of the first taxable year to which it applies and to all such obligations thereafter acquired by him and shall be binding for all subsequent taxable years, unless upon application by the taxpayer the Commissioner permits him, subject to such conditions as the Commissioner deems necessary, to change to a different method. In the case of any such obligations owned by the taxpayer at the beginning of the first taxable year to which his election applies, the increase in the redemption price of such obligations occurring between the date of acquisition (or, in the case of an obligation described in paragraph (2) of subsection (d), the date of acquisition of the series E bond involved) and the first day of such taxable year shall also be treated as income received in such taxable year.

(c) Short-Term Obligations Issued on Discount Basis.—In the case of any obligation of the United States or any of its possessions, or of a State or Territory, or any political

subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, the amount of discount at which such obligation is originally sold shall not be considered to accrue until the date on which such obligation is paid at maturity, sold, or otherwise disposed of.

* * *

(26 U. S. C. 1952 ed., Sec. 42)

Sec. 111. Determination of Amount of, and Recognition of, Gain or Loss.

(a) Computation of Gain or Loss.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

* * *

(26 U. S. C. 1952 ed., Sec. 111)

Sec. 117. Capital Gains and Losses.

(a) Definitions.—As used in this chapter—

(1) Capital Assets.—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

* * *

(D) an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue.

* * *

(2) Short-Term Capital Gain.—The term "short-term capital gain" means gain from the sale or exchange of a

capital asset held for not more than 6 months, if and to the extent such gain is taken into account in computing gross income;

* * *

(4) Long-Term Capital Gain.—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income;

(f) Retirement of Bonds, etc.—For the purposes of this chapter, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.

* * *

(26 U. S. C. 1952 ed., Sec. 117)

Sec. 125. Amortizable Bond Premium.

(a) General rule. In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b)) on the bond for any taxable year beginning after December 31, 1941:

(1) Interest wholly or partially taxable. In the case of a bond (other than a bond the interest on which is excludible from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as a deduction.

(2) Interest wholly tax-exempt. In the case of any bond the interest on which is excludible from gross income, no deduction shall be allowed for the amortizable bond premium for the taxable year.

(3) Adjustment of credit in case of interest partially tax-exempt. In the case of any bond, the interest on which is allowable as a credit against net income, the credit pro-

vided in section 25(a)(1) or (2), or section 26(a), as the case may be, shall be reduced by the amount of the amortizable bond premium for the taxable year. (For adjustment to basis on account of amortizable bond premium see section 113(b)(1)(H).)

* * *

(c) Election on taxable and partially taxable bonds.

(1) Eligibility to elect and bonds with respect to which election permitted. This section shall apply with respect to the following classes of taxpayers with respect to the following classes of taxpayers with respect to the following classes of bonds only if the taxpayer has elected to have this section apply.

(A) Partially tax-exempt.—In the case of a taxpayer other than a corporation, bonds with respect to the interest on which the credit provided in section 25(a)(1) or (2) is allowable; and

(B) Wholly taxable.—In the case of any taxpayer, bonds the interest on which is not excludible from gross income but with respect to which the credit provided in section 25(a)(1) or (2), or section 26(a), as the case may be, is not allowable.

(2) Manner and effect of election.—The election authorized under this subsection shall be made in accordance with such regulations as the Commissioner with the approval of the Secretary shall prescribe. If such election is made with respect to any bond (described in paragraph (1)) of the taxpayer, it shall also apply to all such bonds held by the taxpayer at the beginning of the first taxable year to which the election applies and to all such bonds thereafter acquired by him and shall be binding for all subsequent taxable years with respect to all such bonds of the taxpayer, unless, upon application by the taxpayer, the Commissioner permits him, subject to such conditions as the Commissioner deems necessary, to revoke such elec-

tion. The election authorized under this subsection in the case of a member of a partnership shall be exercisable with respect to bonds of the partnership only by the partnership. In the case of bonds held by a common trust fund, as defined in section 169, or by a foreign personal holding company, as defined in section 331, the election authorized under this subsection shall be exercisable with respect to such bonds only by the common trust fund or foreign personal holding company.

* * *

(26 U. S. C. 1952 ed., Sec. 125)

Sec. 201. Life Insurance Companies.

* * *

(e) Amortization of premium and accrual of discount. The gross income, the deduction provided in section 201(c)(7)(A) and the credit allowed against net income in section 26(a) shall each be decreased by the appropriate amortization of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures or other evidences of indebtedness held by a life insurance company. Such amortization and accrual shall be determined (1) in accordance with the method regularly employed by such company, if such method is reasonable, and (2) in all other cases in accordance with regulations prescribed by the Commissioner with the approval of the Secretary.

* * *

(26 U. S. C. 1952 ed., Sec. 201)

Sec. 207. Mutual Insurance Companies other than Life or Marine.

* * *

(d) Amortization of premium and Accrual of Discount. The gross amount of income during the taxable year from interest, the deduction provided in subsection (b)(4)(A), and the credit allowed against net income in section 26(a) shall each be decreased by the appropriate amortization

of premium and increased by the appropriate accrual of discount attributable to the taxable year on bonds, notes, debentures or other evidences of indebtedness held by a mutual insurance company subject to the tax imposed by this section. Such amortization and accrual shall be determined (1) in accordance with the method regularly employed by such company, if such method is reasonable, and (2) in all other cases, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary.

* * *

(26 U. S. C. 1952 ed., Sec. 207)

SEC. 3791. RULES AND REGULATIONS.

* * *

(b) RETROACTIVITY OF REGULATIONS OR RULINGS. The Secretary, or the Commissioner with the approval of the Secretary may prescribe the extent, if any, to which any ruling, regulation, or Treasury Decision, relating to the internal revenue laws, shall be applied without retroactive effect.

(26 U. S. C. 1952 ed., Sec. 3791)

Internal Revenue Code of 1954

Sec. 171. Amortizable Bond Premium.

(a) General Rule.—In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b)) on the bond:

(1) Interest wholly or partially taxable.—In the case of a bond (other than a bond the interest on which is excludable from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as a deduction.

(2) Interest wholly tax-exempt.—In the case of any bond the interest on which is excludable from gross income, no deduction shall be allowed for the amortizable bond premium for the taxable year.

(3) Adjustment of credit or deduction for interest partially tax exempt.—

(A) Individuals.—In the case of any bond the interest on which is allowable as a credit under section 35, the amount which would otherwise be taken into account in computing such credit shall be reduced by the amount of the amortizable bond premium for the taxable year.

(B) Corporation.—In the case of any bond the interest on which is allowable as a deduction under section 242, such deduction shall be reduced by the amount of the amortizable bond premium for the taxable year.

(4) Cross reference.—

For adjustment to basis on account of amortizable bond premium, see section 1016(a)(5).

* * * *

(c) Election as to Taxable and Partially Taxable Bonds.—

(1) Eligibility to elect; bonds with respect to which election permitted.—This section shall apply with respect to the following classes of taxpayers with respect to the following classes of bonds only if the taxpayer has elected to have this section apply:

(A) Partially tax-exempt.—In the case of a taxpayer other than a corporation, bonds with respect to the interest on which the credit provided in section 35 is allowable; and

(B) Wholly taxable.—In the case of any taxpayer, bonds the interest on which is not excludable

from gross income but with respect to which the credit provided in section 35, or the deduction provided in section 242, is not allowable.

(2) Manner and effect of election.—The election authorized under this subsection shall be made in accordance with such regulations as the Secretary or his delegate shall prescribe. If such election is made with respect to any bond (described in paragraph (1)) of the taxpayer, it shall also apply to all such bonds held by the taxpayer at the beginning of the first taxable year to which the election applies and to all such bonds thereafter acquired by him and shall be binding for all subsequent taxable years with respect to all such bonds of the taxpayer, unless, on application by the taxpayer, the Secretary or his delegate permits him, subject to such conditions as the Secretary or his delegate deems necessary, to revoke such election. In the case of bonds held by a common trust fund, as defined in section 584(a), or by a foreign personal holding company, as defined in section 552, the election authorized under this subsection shall be exercisable with respect to such bonds only by the common trust fund or foreign personal holding company. In case of bonds held by an estate or trust, the election authorized under this subsection shall be exercisable with respect to such bonds only by the fiduciary.

* * *

(26 U. S. C. 1958 ed., Sec. 171)

SEC. 483. INTEREST ON CERTAIN DEFERRED PAYMENTS.

(a) AMOUNT CONSTITUTING INTEREST.—For purposes of this title, in the case of any contract for the sale or exchange of property there shall be treated as interest that part of a payment to which this section applies which bears the same ratio to the amount of such payment as the total unstated interest under such contract bears to the total of the payments to which this section applies which are due under such contract.

(b) Total Unstated Interest.—For purposes of this section, the term "total unstated interest" means, with respect to a contract for the sale or exchange of property, an amount equal to the excess of—

(1) the sum of the payments to which this section applies which are due under the contract, over

(2) the sum of the present values of such payments and the present values of any interest payments due under the contract.

For purposes of paragraph (2), the present value of a payment shall be determined, as of the date of the sale or exchange, by discounting such payment at the rate, and in the manner, provided in regulations prescribed by the Secretary or his delegate. Such regulations shall provide for discounting on the basis of 6-month brackets and shall provide that the present value of any interest payment due not more than 6 months after the date of the sale or exchange is an amount equal to 100 percent of such payment.

(c) Payments to Which Section Applies—

(1) In General.—Except as provided in subsection (f), this section shall apply to any payment on account of the sale or exchange of property which constitutes part or all of the sales price and which is due more than 6 months after the date of such sale or exchange under a contract—

(A) under which some or all of the payments are due more than one year after the date of such sale or exchange, and

(B) under which, using a rate provided by regulations prescribed by the Secretary or his delegate for purposes of this subparagraph, there is total unstated interest.

* * *

SEC. 1232. BONDS AND OTHER EVIDENCES OF INDEBTEDNESS.

(a) [as amended by Sec. 50 of the Technical Amendments Act of 1958, P. L. 85-866, 72 Stat. 1606] *General Rule.*—For purposes of this subtitle, in the case of bonds, debentures, notes, or certificates or other evidence of indebtedness, which are capital assets in the hands of the taxpayer, and which are issued by any corporation, or government or political subdivision thereof—

(1) *Retirement.*—Amounts received by the holder on retirement of such bonds or other evidences of indebtedness shall be considered as amounts received in exchange therefor (except that in the case of bonds or other evidences of indebtedness issued before January 1, 1955, this paragraph shall apply only to those issued with interest coupons or in registered form, or to those in such form on March 1, 1954).

(2) *Sale or Exchange.*—

(A) General rule.—Except as provided in subparagraph (B), upon sale or exchange of bonds or other evidences of indebtedness issued after December 31, 1954, held by the taxpayer more than 6 months, any gain realized which does not exceed—

(i) an amount equal to the original issue discount (as defined in subsection (b)), or

(ii) if at the time of original issue there was no intention to call the bond or other evidence of indebtedness before maturity, an amount which bears the same ratio to the original issue discount (as defined in subsection (b)) as the number of complete months that the bond or other evidence of indebtedness was held by the taxpayer bears to the number of complete months from the date of original issue to the date of maturity, shall be considered as gain from the sale or exchange of property which is not a capital asset. Gain in excess of such amount shall be con-

sidered gain from the sale or exchange of a capital asset held more than 6 months.

* * *

(b) Definitions—

(1) Original issue discount—For purposes of subsection (a), the term "original issue discount" means the difference between the issue price and the stated redemption price at maturity. If the original issue discount is less than one-fourth of 1 percent of the redemption price at maturity multiplied by the number of complete years to maturity, then the issue discount shall be considered to be zero. For purposes of this paragraph, the term "stated redemption price at maturity" means the amount fixed by the last modification of the purchase agreement and includes dividends payable at that time.

* * *

(26 U. S. C. 1958 ed., Sec. 1232)